rather than on account of our own interest, that we enlist our hearty good wishes and earnest coöperation in this cause. We believe, and must express our belief, that our School offers as fine a legal education as any in the country. When the other great schools are crowded to capacity, we think it most proper that the opportunity at Yale should be better known, particularly to Yale men. We therefore urge the support of this association by all Yale men in law. Particularly do we urge upon the students in the School a realization of their obligation to their legal alma mater; we ask their coöperation so far as in them lies at the present time, and not less when they leave the School for the bar.

PROFIT ON INVESTMENTS AS TAXABLE INCOME

An income tax question of no less importance than that involved in the stock dividend case[1] has recently been decided by Judge Thomas of the District Court of the United States for the District of Connecticut, and will shortly be passed upon by the Supreme Court. *Brewster v. Walsh, Collector* (Dec. 16, 1920) U. S. D. C., D. Conn., No. 2133.[2] The problem presented is whether appreciation in value of an investment, realized by sale, is income of the individual investor in such sense as to be subject to federal taxation. That the federal government has been collecting such taxes is known to all; but economists as well as lawyers have not been agreed as to the validity of them, and a judicial expression of opinion on the point has been eagerly awaited. Judge Thomas' decision that such profits are not taxable has consequently aroused much comment both in financial journals and in the daily press.

The facts of the case can be stated briefly. Prior to the effective date of the Sixteenth Amendment,[3] Mr. Brewster, who was not a trader in securities, had purchased for investment certain bonds. He sold these bonds in 1916, part of them at exactly their cost price, others

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[1] *Eisner v. Macomber* (1920) 252 U. S. 189, 40 Sup. Ct. 189; see articles in (1920) 29 YALE LAW JOURNAL, 735; (1920) 33 HARV. L. REV. 885; (1920) 20 COL. L. REV. 536; (1920) 14 AM. POL. SCI. REV. 635; (1920) 5 BULL. NAT. TAX ASSN. 201, 208, 247.

[2] The case is to be taken to the United States Supreme Court. The day after Judge Thomas' decision, a judgment for the government was rendered on demurrer by Judge Hand in a case involving the same point. *Goodrich v. Edwards* (Dec. 17, 1920, U. S. D. C. S. D. N. Y.) This case has also been appealed. The question of the taxability of capital increment realized by sale by a trustee who held securities for life-tenant and remainderman was argued before the Supreme Court on Jan. 11, 1921, in *Merchants' Loan & Trust Co. v. Smietanka,* Oct. Term, 1920, No. 608.

[3] March 1, 1913. The text of the Sixteenth Amendment reads: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration."

at a slight advance over cost. But in each case the sale price was considerably more than the market value of the bonds on March 1, 1913. Such gains over the market value of March 1, 1913, were assessed as income for the year 1916.[4] The tax thereon was paid under protest and suit was brought for its recovery. Judgment was given for the plaintiff on the ground that such realized increment in value was not "income" within the meaning of the term as used in the Sixteenth Amendment, and therefore the tax thereon violated the constitutional requirement that direct taxes shall be apportioned according to population.[5]

To draw a line between what is capital and what is income is a task which baffles economists no less than lawyers.[6] The Supreme Court would have saved itself many troublesome questions could it have left Congress a free hand to make its own definition of income for purposes of taxation. But such a course has been foreclosed. In *Eisner v. Macomber* Mr. Justice Pitney, in discussing the scope of the Amendment, said:[7]

"In order, therefore, that the clauses cited from Article 1 of the Constitution may have proper force and effect, save only as modified by the Amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not 'income,' as the term is there used, and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter. . . ."

With respect to stock dividends and with respect to judges' salaries[8] the court has overturned the Congressional definition of taxable income. It is clear, therefore, that taxes upon profits realized on the sale of securities cannot stand if the Court shall be of opinion that "according to truth and substance" such profits are not income.

Increase in value of capital, before it is realized by sale, is con-

[4] Unquestionably the Revenue Act of 1916 (39 Stat. at L. ch. 463, p. 756) purports to tax such gains. Sec. 1 (a) lays a tax upon "the entire net income received in the preceding calendar year from all sources by every individual." Sec. 2 (a) declares that the net income of a taxable person "shall include gains, profits and income derived from . . . sales, or dealings in property." Sec. 2 (c) provides that "for the purpose of ascertaining the gain derived from the sale or other disposition of property . . . acquired before March 1, 1913, the fair market price or value of such property as of March 1, 1913, shall be the basis for determining the amount of such gain derived."

The Revenue Act of 1918, sec. 213 (Act of Feb. 24, 1919) similarly includes such "gains" as income. Sec. 214 permits the deduction of losses on investments realized by sale.

[5] U. S. Const. Art. 1, sec. 2, clause 3, and sec. 9, clause 4.

[6] See *Some Income Tax Problems* (1920) 29 YALE LAW JOURNAL, 735, and citations in the notes thereto.

[7] 40 Sup. Ct. 189, at 193.

[8] *Evans v. Gore* (1920, U. S.) 40 Sup. Ct. 550; for criticisms of this decision see (1920) 30 YALE LAW JOURNAL, 75; (1920) 6 AM. BAR. ASSO. J. 202.

cededly not income.[9] So long as an item of property continues in the same ownership, appreciation in its value is not income to the owner, but when the owner exchanges the article for another of equal value, or for money, then such appreciation in value, which had previously been deemed capital, becomes on the instant income and only so much of the value as represents the original cost of the article or its value on March 1, 1913, continues to remain capital—this is the position of the advocates of the taxability of capital gains. Whatever else may be said of it, it can scarcely be called logical.[10] Advocates of either view, however, can find aid and comfort in the language of Supreme Court opinions.

In a case which arose under the Income Tax Law of 1867, Mr. Justice Field declared:[11]

"The question presented is whether the advance in value of the bonds, during this period of four years, over their cost, realized by their sale, was subject to taxation as gains, profits, or income of the plaintiff for the year in which the bonds were sold. . . ."

"The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated merely as an increase of capital."

Respecting this decision, the Supreme Court, by Mr. Justice McKenna, has recently stated that, "This case has not been since questioned or modified."[12]

On the other hand, Mr. Justice Pitney, in the course of his opinion in *Eisner v. Macomber,* said:[13]

"It is said that a stockholder may sell the new shares acquired in the stock dividend; and so he may, if he can find a buyer. It is equally true that if he does sell, and in doing so realizes a profit, such profit, like any other, is income, and so far as it may have arisen since the Sixteenth Amendment is taxable by Congress without apportionment. The same would be true were he to sell some of his original shares at a profit."

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[9] In *Eisner v. Macomber, supra* note 1, at p. 193, Mr. Justice Pitney, in discussing the definition of income, says (italics are his): "the *gain—derived—from—capital,* etc. Here we have the essential matter: *not a* gain *accruing to* capital; not a *growth* or *increment* of value in the investment; but a gain, a profit, something of exchangeable value, *proceeding from* the property, *severed from* the capital, however invested or employed, and *coming in,* being *"derived"*—that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal—*that* is income derived from property."

[10] For criticism by an economist, see *Federal Taxation of Income and Profits,* a paper read before the American Economic Association at its annual meeting, December 29, 1920, and shortly to be published in the AM. ECON. REV. For a discussion favoring the tax see (1920) 29 YALE LAW JOURNAL, 738-741.

[11] *Gray v. Darlington* (1872, U. S.) 15 Wall. 63, 65 and 66.

[12] *Lynch v. Turrish* (1918) 247 U. S. 221, 230, 38 Sup. Ct. 537, 539.

[13] 40 Sup. Ct. 189, 195.

These statements, however, are treated by Judge Thomas as dicta[14] which must be confined in their application to traders in stocks, or else be treated as contradictory to the decision in *Gray v. Darlington,* and of inferior authority. Other cases[15] relied upon by the government, wherein it was held that gains realized by sale formed part of the corporation's income taxable under the Corporation Tax Act of 1909, are distinguished because this Act imposed not an income but an excise tax.[16]

The argument against the taxability of realized capital appreciation finds further support in the construction of the British Income Tax Act[17] and in cases involving securities held on trust for life-beneficiary and remainderman.[18] As between life tenant and remainderman, it is clear that capital increment still remains capital after realization by sale. If an income tax is assessed upon such increment, who is to pay it? Not the life-tenant, it would seem, for he has not received and will not receive the increment—unless its reinvestment by the trustee can be deemed a receipt by the life-tenant; nor the remainderman, for he has not received it and may never do so. If the trustee is deemed to have received taxable income, his payment of the tax necessarily reduces money which he holds solely for investment, that is, as capital.[19] The tax, if paid, must come out of property which all parties consider, and are required by law to consider, as capital. With regard to securities held on trust, therefore, sale for reinvestment should not be held to sever increment from capital so as to make it income for purposes of taxation. With respect to profits realized by an individual investor, he would be a bold man who would predict, with assurance, what the Supreme Court decision will be, but it is believed

[14] It is unofficially reported that in the argument of *Merchants' Loan and Trust Co. v. Smietanka, supra* note 2, when this language in the *Macomber* opinion was being pressed upon the court, Mr. Justice Pitney stated from the bench that counsel might consider it as dictum.

[15] *Doyle v. Mitchell Bros. Co.* (1918) 247 U. S. 179, 38 Sup. Ct. 467; *Hays v. Gauley Mountain Coal Co.* (1918) 247 U. S. 189, 38 Sup. Ct. 470; *Southern Pac. Co. v. Lowe* (1918) 247 U. S. 330, 38 Sup. Ct. 540.

[16] *Stratton's Independence v. Howbert* (1913) 231 U. S. 399, 404, 34 Sup. Ct. 136; *Anderson v. Forty-two Broadway Co.* (1915) 239 U. S. 69, 36 Sup. Ct. 7.

[17] See *Tebrau Rubber Syndicate v. Farmer* (1910) 47 Scot. L. R. 816, at 819: "It is well settled that in such a case the profit is not part of the person's annual income liable to be assessed for income tax but results from an appreciation of his capital. No doubt if it is part of his business to deal in land or investments, any profits which in the course of that business he realizes form part of his income; . . ."

[18] *Boardman v. Mansfield* (1907) 79 Conn. 634, 66 Atl. 169; *Smith v. Hooper* (1902) 95 Md. 16, 51 Atl. 844; *Jordan v. Jordan* (1906) 192 Mass. 337, 78 N. E. 459; *Gibbons v. Mahon* (1890) 136 U. S. 549, 10 Sup. Ct. 1057.

[19] In *Merchants' Loan & Trust Co. v. Smietanka,* referred to in note 2 *supra,* appellant's brief contains the argument that, even if capital appreciation realized by an individual be deemed taxable income, sec. 2 (b) of the Revenue Act of 1916 cannot properly be construed as intended to impose such a tax upon a trustee.

that the judgment in the *Brewster* Case should be affirmed.[20] As to those bonds which were sold at cost, it seems particularly difficult to say that the increment above market value on March 1, 1913, is income. Even if the meaning of "income" in the Amendment be deemed broad enough to include a realized profit over cost, it is not likely to be stretched to cover appreciation in value which simply offsets a previous decrease and actually represents no profit over cost. Judge Thomas found it unnecessary to pass upon this point because of his broader holding that realized profit on investments was not taxable income.

Affirmance by the Supreme Court would, of course, destroy a large source of revenue from income taxes. On the other hand it would justify the repeal of the provision which permits the deduction of losses from sale of investments.[21] The economic effect of the existing practice of taxing gains and allowing deduction of losses is undoubtedly bad. It deters the tax payer from realizing gains, and furnishes an incentive to realize losses and to withdraw capital from business enterprise for the purpose of investment in tax-exempt securities.[22] This is particularly true in the case of taxpayers of large income where such deduction may effect the rate of surtax. As is well known, it is common practice to sell investments for the very purpose of realizing a loss for income tax purposes, and to repurchase immediately the same securities. It may be doubted, therefore, whether the actual loss of revenue would be as great as is anticipated, if capital losses as well as capital gains were both excluded from consideration.

T. W. S.

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[20] For discussion of an analogous problem, see McCamic, *Appreciation in Value as Invested Capital under the Excess Profits Law* (1920) 30 YALE LAW JOURNAL, 239.

[21] The Income Tax Law of 1913, except in the case of a trader, did not permit realized investment losses to be deducted from income. See *Mente v. Eisner* (1920, C. C. A. 2d) 266 Fed. 161, discussed in (1920) 34 HARV. L. REV. 220.

The Revenue Act of 1916 permitted such losses to be offset only to the extent of realized investment gains. In effect this treats them as capital losses, for if they were income losses they should be taken into account in determining "net income" which the Act purports to tax.

The Revenue Act of 1918, sec. 214, permits the tax payer to offset against his entire income realized investment losses.

[22] The *ratio decidendi* of *Evans v. Gore,* note 8 *supra,* makes it certain that income from state and municipal bonds is tax-exempt. The existence of millions of dollars of tax-exempt securities is the most vicious feature of our entire scheme of income taxation. Unfortunately, there seems no way to meet it but by a constitutional amendment doing away with the necessity for apportionment in direct taxes—unless the Supreme Court will recant the views expressed in *Evans v. Gore.* An unanswerable criticism of that decision may be found in Mr. Harry Hubbard's article *From Whatever Source Derived* (1920) 6 AM. BAR. Asso. J. 220. The economic evils are discussed by Mr. Otto H. Kahn in *Two Years of Faulty Taxation* (1920) 10-32 and *Some Suggestions on Tax Revision* (1920) 12-20.